AFG July 2008 Style Sector Book

July 7, 2008

While turbulent March is still fresh in our minds, as Bear Stearns came to its demise, June was much worse. The AFG universe returned a negative 9.05% (5/30/2008-6/27/2008), vs. a 4.95% loss in March. To put the month into perspective, we looked at monthly and quarterly S&P 500 returns going back to January 1950. The month and second quarter ending June 2008 ranked among the top 15% worst performing quarters over that time period, with a negative 8.85% return. Sadly, the first quarter ending March 2008 resulted in even worse performance, with the S&P 500 returning a negative 11%, putting it among the top 10% worst performing quarters. Given that we constantly hear in the media that the market is a leading indicator for the economy, what can we expect in the year ahead with such dismal winds at our backs? Again looking back to the 1950's, and focusing on the 10% worst performing quarters for the S&P 500 to see how the economy and market subsequently performed, we discovered the results for future historically have not been nearly as dismal as the media would have us believe. First on the economy, over the next 12 months after a horrible S&P 500 quarter, GDP grew 2% in real terms, while this is below the 3.3% average real growth registered from 1947 to 2008, it is by no means tragic! More interesting, the 12 months following a worst 10% performing S&P 500 quarter tends to be favorable to the equity market, returning on average 8.4%, in line with the indexes performance since 1950. Just as interesting, the data is very positively tilted towards positive returns and economic growth in the subsequent 12 months, as 75% of the time the S&P500 registered positive returns and the 87% of the time Real GDP increased. Bottom line, the market looks forward and incorporates likely bad news into today's prices paving the way for a future market rebound. Lets take a look at why June turned out to be such a poor performing month.

Headlines were all about inflation. Inflation was everywhere, oil, steel, food, but unfortunately not for the housing sector as house prices continued to fall. Consumers are pinched and pinched, and their confidence dropped to a 28 year low. While nobody can deny what people feel, this confidence dive seems over-sold. Very likely it is a relative comparison of today against the past 5 years, which witnessed a significant productivity boom and overall economic prosperity. The current economy we are in, is by all means, not comparable to the Carter era, which launched double digit inflation until Volker, with Regan's blessing, ended it in the early 80's. Our economy is still growing; our unemployment rate is just 5.5%, compared to the high single and low double digits of the late 70's and early 80's; inflation is at 4-5%, not double digits; the major European countries – namely UK, France, and Germany have pro-America governments; and we will likely have a new ally in the Middle east – Iraq, with more time.

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We are of course concerned about the current price of oil, but we are also pleased by the possible positive long term impact of this oil "crisis". While every country around the world celebrates finding oil, the United States has until recently felt a sense of guilt or disgust. Fortunately, public opinion has shifted to favor off shore drilling. Surprisingly the greatest change in opinion according to a recent Pew poll has taken place among self-identified liberals, who previously were against drilling and adding new power plants in the country (http://people-press.org/report/433/gas-prices). Should this shifted public opinion lead to increased drilling and energy production, market prices for oil will likely decline. It is bewildering that the US has given our $ to our enemies, enduring high oil prices, while letting our large oil reserve sit idle. It is encouraging that the American people, while doing what they can to preserve the environment, are now acknowledging the technological progress we have made in exploring oil in an environmentally friendly way, and are open to change their mind regarding intermediate term energy production. More encouraging is the increasing amount of capital flowing to alternative energy as a permanent solution. For example, legendary independent oilman T. Boone Pickens recently inked a deal to build a $3 Billion wind farm in Texas. Solar technologies continue to improve in efficiency, and most importantly plug-in automobiles are likely to appear on the market soon. The largest use of oil in America is to power cars, thus true "plug-in" electric autos are a critical first step to move from an oil based transportation economy to an electric one. When this happens, oil's primary purpose will be for plastic and other by-products, very much reducing the strategic importance many of the world's despots now seem to relish.

It was a bad month for Financials. Lehman was rumored to end up with the same fate of Bear Stearns', and a Goldman Sachs analyst estimates the US banks will need an additional $65 billion capital infusion as the global credit crisis won't peak until 2009. There are still record foreclosures and inventory of houses unsold, plus, the delinquency of consumer credit card payments are increasing. There will be a long way to go before financial companies complete their de-leveraging and can take a breath of fresh air, if they are not among those that suffocate first.

On a nicer note, June marked our 5th annual research summit at the Wynn Resort in Las Vegas. The feedback from the event has been tremendous as we offered our best event to date. Our speakers discussed the importance of psychology to protests in China on the investment decision, in addition to great training and our usual stellar picks for the coming year. If you did not attend, we hope you consider us for your conference plans next year as unlike most conferences, everyone attending leaves with unique, actionable research they can immediately put to work for their clients.

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The returns from May 30 to June 27, 2008 are the following:

20 Day Return (%)			
AFG Universe	**-9.05**		
Large Growth	-6.65	Energy & Extraction	5.71
Small Growth	-7.23	Health	-4.68
Growth	-7.39	Utilities	-5.75
Large	-7.84	Capital Goods	-6.84
Mid Growth	-8.22	Consumer Non Durable	-8.67
Mid	-9.56	Basic Materials	-9.07
Small	-9.65	Technology	-9.09
Large Value	-9.88	Consumer Services	-10.99
Value	-10.71	Consumer Durable	-11.79
Small Value	-10.84	Transportation	-13.52
Mid Value	-11.13	Financials	-14.54

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